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# Usury Law in North Carolina

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## COMMENTS

### Usury Law in North Carolina

#### INTRODUCTION

"[T]he usury ceiling . . . threatens to pinch the Tar Heel economy," says a North Carolina newspaper in advocating a "rewriting [of] North Carolina's usury laws."<sup>1</sup> This editorial comment epitomizes the current furor about general usury<sup>2</sup> laws, which purport to fix a maximum cost for credit but which fail to deal adequately with the realities of the market place. A recent "credit crunch"<sup>3</sup> has made both business borrowers and home buyers aware that the usury laws of the past are ill-suited to a credit economy. The consumer has found that usury statutes offer him little protection.<sup>4</sup> This comment will examine North Carolina's statutory and judicial usury law through an exposition of its present state and a critique of its present value.

#### HISTORY

Although usury is a topic of much currency, laws regulating the price of money are by no means of recent origin. The Kingdom of Eshunna in Mesopotamia limited interest to 16 $\frac{2}{3}$  percent per annum in 2000 B.C.<sup>5</sup> Under Mosaic law, any return upon property loaned to a fellow believer

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<sup>1</sup> Raleigh (N.C.) News and Observer, Feb. 11, 1969, at 4, col. 1. See also Charlotte (N.C.) Observer, Jan. 15, 1969, § C, at 2, col. 1.

<sup>2</sup> "Interest" is defined as the compensation allowed by law or fixed by the parties for the use or forbearance of money. *Brown v. Hialts*, 82 U.S. 177 (1872). "Usury" is the taking or reserving of an illegal profit for the use of money. *MacRackan v. Bank of Columbus*, 164 N.C. 24, 80 S.E. 184 (1913). The *Restatement of Contracts* defines a usurious bargain as one "under which a greater profit than is permitted by law is paid, or is agreed to be paid to a creditor by or on behalf of the debtor for a loan of money, or for extending the maturity of a pecuniary debt . . ." RESTATEMENT OF CONTRACTS § 526 (1932).

<sup>3</sup> With the cost of funds rising, banks raised the prime loan rate that they charge their best corporate borrowers to seven percent in January, 1969. *Financial Developments in the Fourth Quarter of 1968*, FEDERAL RESERVE BULL., Feb. 1969, at 96. "[M]arket interest rates rose sharply in the fourth quarter of 1968, reaching new record highs in many cases by around year-end." *Id.* 89

<sup>4</sup> See, e.g., NORTH CAROLINA CONSUMER COUNCIL, *THE TRUTH ABOUT THE COST OF CREDIT* (1969).

<sup>5</sup> Shanks, *Practical Problems in the Application of Archaic Usury Laws*, 53 VA. L. REV. 327, & n.5 (1967) [hereinafter cited as Shanks].

was forbidden.<sup>6</sup> Restrictions placed upon interest-taking by the medieval Christian church approached absolute prohibition. Usurers were adjudged guilty of a mortal sin and excommunicated as loans were regarded as help owed one's neighbor rather than as tools of trade. During the Renaissance a new concern for commercial expediency demanded a modification of canon law. Compensation for loans was first allowed only as reimbursement for the loss of money's use. The Protestant Reformation added impetus to the trend. In 1547, Calvin fixed the maximum interest rate for Geneva at five percent per annum.<sup>7</sup>

Interest was allowed in seventeenth-century England only upon a strictly regulated basis. The statute 12 Anne c. 16<sup>8</sup> served as the prototype for usury statutes in the American colonies. North Carolina's first usury law, the Act of 1741, rendered "utterly void 'all bonds, contracts, and assurances whatsoever, . . . for the payment of any principal or money to be lent . . . upon or for any usury, whereupon there shall be reserved or taken' interest in excess of the legal rate prescribed."<sup>9</sup> This act was superseded by the Act of 1876-77, which constitutes a substantial part of the present North Carolina general usury statute.<sup>10</sup> No longer is a usurious contract wholly void. The statutory penalty is now forfeiture of all interest reserved by the lender or twice the amount of interest actually paid by the borrower.<sup>11</sup>

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<sup>6</sup> "Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything. . . ." *Deuteronomy* 23:19-20 (King James). This theme was expanded in the New Testament: "[L]end, hoping for nothing thereby." *Luke* 6:35 (King James).

<sup>7</sup> See generally B. DEMPSEY, *INTEREST AND USURY* (1943); S. HOMER, *A. HISTORY OF INTEREST RATES* (1963); F. RYAN, *USURY AND USURY LAWS* 25-32 (1924).

<sup>8</sup> 12 Anne c. 16 (1714) is quoted at n.11, Comment, *Usury Laws and the Corporate Exception*, 23 MD. L. REV. 51, 52 (1963).

<sup>9</sup> *Commercial Credit Corp. v. Robeson Motors, Inc.*, 243 N.C. 236, 330, 90 S.E.2d 886, 889 (1956), quoting Act of 1741, Potter's Revisal of 1819, ch. 28.

<sup>10</sup> N.C. GEN. STAT. § 24-2 (1964). In *Merchants' & Farmers' Nat'l Bank v. Myers*, 74 N.C. 514 (1875), the North Carolina Supreme Court held that the state usury statute did not apply to national banks, basing its opinion on *Farmers' & Mechanics' Nat'l Bank v. Dearing*, 91 U.S. 29 (1875). Therefore, the General Assembly enacted legislation (Laws of 1876-1877, ch. 91) substantially the same as that applicable to national banks under federal statute 12 U.S.C. § 86 (1967). See *Commercial Credit Corp. v. Robeson Motors, Inc.*, 243 N.C. 326, 90 S.E.2d 886 (1956).

<sup>11</sup> N.C. GEN. STAT. § 24-2 (1964) states:

[T]he taking, receiving, reserving or charging a greater rate of interest than six per centum per annum . . . when knowingly done, shall be a forfeiture of the entire interest which the evidence of debt carries with it . . . . And in case a greater rate of interest has been paid, the person or his legal representatives . . . may recover back twice the amount of interest paid . . . .

From a moral doctrine of canon law, interest regulation evolved into an exercise of police power intended to protect "the needy borrower, a victim of the rapacious lender."<sup>12</sup> The concept of overreaching has played a particularly important part in the justification of general usury laws, which have long been under attack from the laissez-faire economists<sup>13</sup> and businessmen. This justification, however, has little basis in fact. Because general usury statutes fail to discriminate realistically as to what and to whom they apply, they have been termed "blunt instruments of social control. Unrefined and clumsy, they are also ineffective."<sup>14</sup>

The central questions implicit in the usury debate are: (1) Which borrowers really need protection from "rapacious lenders"? (2) To what extent can interest rates be effectively regulated in a modern credit system? The existing statutory and case law furnishes no viable answers. Faced with a single fixed maximum interest rate applicable in all credit situations, the legislatures and the courts have eschewed thorough reform in favor of haphazard ad hoc exceptions. Indeed, the general usury law is now honored more in the legal exception than in the observance.

#### THE STATUTES

"Existing state legislation regulating maximum interest rates is typically a jumble of statutes fixing a basic usury rate and then exempting from the basic rate"<sup>15</sup> various lenders and particular types of loans. This is particularly true of North Carolina legislation.<sup>16</sup> Interest regulations are found in *North Carolina General Statutes*, Chapters 24, Interest; 53, Banks; and 54, Co-operative Organizations.<sup>17</sup> N.C. GEN. STAT. § 24-1

<sup>12</sup> *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 340, 132 S.E.2d 692, 695 (1963), *quoting with approval* *GMAC v. Weinrich*, 262 S.W. 425 (Mo. 1924).

<sup>13</sup> One of the most effective attacks was by utilitarian economist Jeremy Bentham, who contended that "no man of ripe years and sound mind, acting freely and with his eyes open, ought to be hindered . . . from making such bargain, in the way of obtaining money, as he thinks fit . . ." J. BENTHAM, *DEFENSE OF USURY*, *quoted in* S. HOMER, *A HISTORY OF INTEREST RATES* 81 (1963).

<sup>14</sup> Shanks 329.

<sup>15</sup> Benfield, *Money, Mortgages and Migraine—the Usury Headache*, 19 CASE W. RES. L. REV. 819, 835 (1968) [hereinafter cited as Benfield]. For a synopsis of existing state credit law, see CCH CONSUMER CREDIT GUIDE or P-H CREDIT UNION GUIDE.

<sup>16</sup> "Usury is not illegal at common law, but is made so by statute in most of the United States as to some or all kinds of loans." RESTATEMENT OF CONTRACTS § 526, Introductory Note (1932).

<sup>17</sup> N.C. GEN. STAT. § 25-9-201 (1965) provides that nothing in Article 9 of the U.C.C. shall validate any charge or practice illegal under the usury laws. Article 9 does not, therefore, create any exceptions to the general usury statute.

(1964) sets the legal rate of interest at "six per cent per annum for such time as interest may accrue and no more." Exceptions<sup>18</sup> to this rate, set forth in Chapter 24, are worded as exemptions from the legal rate; however, exceptions found in other chapters are phrased as grants of corporate power, with no reference to the general usury statute. Though the question has never been litigated, these grants of power have been generally regarded as *in pari materia* with the usury statute<sup>19</sup> and, therefore, as exemptions from its coverage. This interpretation is consistent with legislative intent that these positive extensions of corporate power serve as "escape valves" to release the pressures exerted upon the interest ceiling by an expanding economy.<sup>20</sup>

### *Certain Institutional Lenders*

The most important of the exceptions expanding corporate power is that allowing commercial banks, savings and loan associations, and industrial banks to deduct in advance from the proceeds of a loan interest

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<sup>18</sup> There is some question about the constitutionality of the exemption of certain classes of lenders or borrowers from the general usury statute. N.C. CONST. art. I, § 7 provides that "[n]o person or set of persons are entitled to exclusive or separate emoluments or privileges from the community . . ." In holding that certain legislation did not exempt insurance companies from the six percent rate limit, the North Carolina Supreme Court said in *Cowan v. Security Life & Trust Co.*, 211 N.C. 18, 188 S.E. 812 (1936), that "if the effect of [the legislation] is to exempt insurance companies from [the general usury statute] . . . and thereby to authorize insurance companies to charge, retain, or receive interest on loans . . . at a greater rate of interest than six per centum per annum, this contention [of unconstitutionality] must be sustained." *Id.* at 21, 188 S.E. at 814. See also *Rowland v. Building and Loan Ass'n*, 116 N.C. 877, 22 S.E. 8 (1895) (General Assembly has no power to grant exceptions to the general usury statute); *Simonton v. Lanier*, 71 N.C. 498 (1874) (General Assembly cannot grant special privileges in a bank's charter). Other cases, however, apparently recognize exceptions to the usury statute although they do not involve the constitutional issue. See, e.g., *Huski-Bilt, Inc. v. First-Citizens Bank & Trust Co.*, 271 N.C. 662, 157 S.E.2d 352 (1967); *Kornegay v. City of Goldsboro*, 180 N.C. 441, 105 S.E. 187 (1920). *State v. Glidden*, 228 N.C. 664, 46 S.E.2d 860 (1948), recognizes that valid classifications can be made under Art. I, § 7 if they are based on reasonable distinctions; however, this decision did not involve the usury statutes.

<sup>19</sup> See, e.g., Poyner, *Some Practical Aspects of the North Carolina Law of Usury*, 12 N.C. BAR NOTES 3 (1960).

<sup>20</sup> For an explanation of how the price of money is determined in the credit market, see Benfield 826-828. See also Merrimen & Hanks, *Revising Usury Statutes in Light of a Tight Money Market*, 27 MD. L. REV. 1 (1967). For a discussion of the various legal responses to economic pressures upon interest limits, see Shanks 331-34. According to Shanks, the major devices used to soften the impact of general usury laws are: (1) to raise the maximum rate well above normal market price levels; (2) to reduce penalties for violation; (3) to enact a corporate exception; and (4) to have the courts recognize the "time price" doctrine exempting credit sales.

up to six percent per annum upon the entire principal. The interest may be "discounted" and computed on the entire principal even though the loan is to be repaid in installments.<sup>21</sup> Therefore, if a qualified lender makes a one thousand dollar loan to be repaid in twelve monthly installments and deducts sixty dollars interest from the proceeds in advance, he lawfully reaps a return of approximately 11.8 percent simple annual interest. The interest rate quoted to the borrower is "six percent."

Commercial banks and industrial banks are also authorized to charge, in connection with these loans, fixed fees based on the amount loaned.<sup>22</sup> This authorization has been widely interpreted by lenders to mean that such fees may be charged in addition to six percent interest. While the statute does not explicitly state<sup>23</sup> an exception to the general usury law for expense fees, the accepted interpretation is justified in light of decisions from other jurisdictions. The general rule is that fees are not considered interest so long as they furnish consideration for collateral services performed by the lender rather than consideration for the loan.<sup>24</sup> Examples of allowable fees are those for a credit report, title examination, drafting, and inspection of real property. Fees chargeable under N.C. GEN. STAT. § 53-141 (1964) are "to cover expenses, including any examination of the character and circumstances of the borrower . . . ." This language apparently contemplates application of the general rule. If fees according to the statutory schedule be also deducted in advance from the one thousand

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<sup>21</sup> N.C. GEN. STAT. § 53-43(6) (1964) and N.C. GEN. STAT. § 53-141(3) (1964) must be construed together in order to see the whole of this exception, which extends to commercial banks, savings banks, savings and loan associations, trust companies and industrial banks, whether they operate under federal or state charter, and to no other lenders. N.C. GEN. STAT. § 53-43(6) (1964) limits savings and loan associations in exercising the powers granted therein to loans of less than three years duration and less than fifteen hundred dollars in amount. The practice of deducting interest in advance is known as "discounting" or "add-on" and is discussed fully, *infra*.

<sup>22</sup> N.C. GEN. STAT. § 53-141 (1964), granting the fee privilege to industrial banks, is incorporated by reference in N.C. GEN. STAT. § 53-43 (1964), thus extending the former to commercial banks.

<sup>23</sup> Cf. VA. CODE ANN. § 6.1-324(3), (5) (1966), which states that "out-of-pocket expenses in connection with making the loan, including the cost of title examination, title insurance, recording fees, taxes, insurance, . . . appraisals, credit reports, surveys and attorney's fees" are not to be treated as interest.

<sup>24</sup> *E.g.*, Real Estate Trustee, Inc. v. Rebhan, 153 Md. 624, 139 A. 351 (1927). An early North Carolina case, and the only one directly in point, held that where the lender made a small charge for travel expenses in excess of the legal interest rate, the transaction was not usurious. Massey, McKesson & Co. v. McDowell, 20 N.C. 252 (1838).

dollar loan postulated in the preceding paragraph, the effective simple annual interest rate becomes approximately 13.6 percent.<sup>25</sup>

### *Residential Loans*

An exception for residential loans<sup>26</sup> was created by the 1967 General Assembly in response to an outcry in the housing market. A maximum of seven percent per annum "simple interest on the unpaid principal balance" agreed upon in writing may be charged on any "direct reduction"<sup>27</sup> or "construction"<sup>28</sup> loan that is secured by "residential property."<sup>29</sup> Loans made within the bounds of this exception are specifically protected from the penalties of the usury statute.

Ancillary profits received by the lender in addition to the allowable interest upon such a loan are strictly regulated. A prepayment penalty of one percent of the outstanding balance may be exacted from the borrower for prepayment within one year after the first payment on principal. After that one-year period, no such fee may be collected.<sup>30</sup> No lender can reserve or receive from any "agent, seller, or broker," or from the borrower, any fees or discounts that, in the aggregate, benefit the lender to an extent exceeding one percent of the principal.<sup>31</sup> A breach of this profit limitation is apparently intended to constitute a violation of the usury laws, although the statutes do not explicitly so state.

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<sup>25</sup> Finance charges can be converted into approximate simple annual interest by this formula:

$$r = \frac{2pC}{A(n+1)}$$

$r$  = annual interest

$p$  = number of payment periods in one year exclusive of down payment

$C$  = interest or finance charges in dollars

$A$  = amount of proceeds received by borrower

$n$  = number of equal installment payments in the whole contract period exclusive of down payment.

Comment, *Retail Credit Sales and Usury*, 24 LA. L. REV. 822, 840 n.95 (1963). For a collection of cases on interest computation and usury, see 57 A.L.R.2d 630 (1958).

<sup>26</sup> N.C. GEN. STAT. § 24-10 (Supp. 1967).

<sup>27</sup> A "direct reduction loan" is apparently a loan obtained to finance the purchase of existing residential property. The statute requires adherence to a schedule of payments to be made at least quarterly, beginning within ninety days after execution of the note. N.C. GEN. STAT. § 24-10(1) (Supp. 1967).

<sup>28</sup> A "construction loan" is to be disbursed as construction progresses and is to be repaid within eighteen months after the note is executed unless the borrower has obtained a direct reduction loan. N.C. GEN. STAT. § 24-10(2) (Supp. 1967).

<sup>29</sup> "Residential property" is realty on which there is or will be constructed one or more dwelling units, each of which house not more than four families. N.C. GEN. STAT. § 24-10(3) (Supp. 1967).

<sup>30</sup> N.C. GEN. STAT. § 24-10 (Supp. 1967).

<sup>31</sup> N.C. GEN. STAT. § 24-11 (Supp. 1967).

*Small Loan Act*

The North Carolina Consumer Finance Act<sup>32</sup> exempts many small personal loans from the state's usury laws. Its purpose is to prevent, through the licensing and supervision of lenders, sharp practices detrimental to impecunious or commercially naive borrowers. Any person or organization in the business of lending amounts of six hundred dollars or less for interest exceeding the legal rate must be licensed and must comply with the regulatory provisions of the act.<sup>33</sup> In addition to criminal penalties for violations, any loan not in compliance is rendered void and the lender has "no right to collect or retain any principal or charges whatsoever . . . ."<sup>34</sup> Loans made by a licensee are limited to six hundred dollars in amount and twenty-five months in duration. A schedule of finance charges allows the lender a high return because of the high risk presumably inherent in most small loans and of administrative costs that vary little with the size of the loan.<sup>35</sup> For example, a charge of fifteen dollars is allowed for seventy-five dollars in proceeds actually received by the borrower. Should the principal be repaid in twelve equal monthly installments, the simple annual interest rate is approximately thirty-five percent.

*Corporate Exception*

Many states do not allow a corporation to raise the defense of usury.<sup>36</sup> Two reasons are normally given for this corporate exception.<sup>37</sup> The business corporation is organized for the concentration of capital and does not

<sup>32</sup> N.C. GEN. STAT. §§ 53-164 to -191 (1965), as amended (Supp. 1967). This act is based on the Uniform Small Loan Act, which has been widely adopted among the states and constitutes a response to the "loan shark" problem. In 1961, there were 593 small loan offices in North Carolina with \$116,760,000 in resources. See W. SIMPSON, AMERICA'S SMALL LOAN PROBLEM 78 (1963); see generally, Simpson, *The Loan Shark Problem in the Southeastern States*, 19 LAW & CONTEMP. PROB. 68 (1954).

<sup>33</sup> N.C. GEN. STAT. § 53-191 (1965) excludes from coverage by the Consumer Finance Act certain lenders, including auto financiers, commercial banks, industrial banks, and savings and loan associations.

<sup>34</sup> N.C. GEN. STAT. § 53-166 (1965).

<sup>35</sup> N.C. GEN. STAT. § 53-173 (1965). The lender may make no charges beyond those authorized. N.C. GEN. STAT. § 53-178 (1965).

<sup>36</sup> E.g., MD. ANN. CODE art. 23, § 125 (1957). "No corporation shall interpose the defense of usury in any action." North Carolina's statute treats corporations as natural persons, in the absence of contrary legislation. *Commissioners v. Atlantic & N.C.R.R.*, 77 N.C. 289 (1877).

<sup>37</sup> The corporate exception was first enacted in New York in response to the decision in *Dry Dock Bank v. American Life Ins. & Trust Co.*, 3 N.Y. 344 (1850), which held void a bank's obligation to repay two hundred fifty thousand dollars loaned to it in a reasonable commercial transaction. Shanks 346.



need protection against lenders. Furthermore, the corporation is the "prime vehicle" of commerce and should not be subjected to the restraint that the usury laws place upon the flow of capital.<sup>38</sup> Subscribing to a limited extent in these theories, the North Carolina legislature has created partial exemptions for corporate borrowers. These are specifically stated in General Statutes Chapter 24, Interest. Private corporations are authorized to sell their "coupon bonds" at a discount.<sup>39</sup> This provision was enacted in response to a decision<sup>40</sup> holding the discount sale of corporate bonds bearing the maximum legal interest to be a loan at an illegal effective rate. Therefore, its application is properly limited to the bona fide public marketing of corporate bonds paying interest through the coupon device. Private corporations may also contract with any lender for liabilities to be discharged by installments bearing a maximum rate of six percent per annum calculated upon the entire amount of the loan for the duration of the loan.<sup>41</sup> The importance of this authorization, however, is diminished by those exceptions discussed above that allow commercial banks and certain other lenders to calculate in this manner interest upon loans to any borrower.

Another corporate exemption<sup>42</sup> allows any lender to charge and any corporation to pay interest up to eight percent per annum where the agreement calls for thirty thousand dollars or more in a lump sum loan or in a series of future advances to be repaid in at least that amount. To qualify for such treatment, the loan must mature at least five years from its inception, and payments must not exceed one-fifth of the principal in any of the first five years of the loan's term. This statute does not authorize discounting of interest or calculation of interest upon the whole principal notwithstanding the payment of installments. An individual guarantor, endorser, or surety for such a loan is specifically limited in his liability for interest to six percent per annum.<sup>43</sup>

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<sup>38</sup> *Carozza v. Federal Fin. & Credit Co.*, 149 Md. 223, 131 A. 332 (1925), quoted in Comment, *Usury Laws and the Corporate Exception*, 23 Md. L. Rev. 51, 55 (1962).

<sup>39</sup> N.C. GEN. STAT. § 24-2 (1965).

<sup>40</sup> *Commissioners v. Atlantic & N.C.R.R.*, 77 N.C. 289 (1877).

<sup>41</sup> N.C. GEN. STAT. § 24-2 (1965).

<sup>42</sup> N.C. GEN. STAT. § 24-8 (1965).

<sup>43</sup> While the corporate exception has not been litigated in North Carolina, cases from other jurisdictions indicate that it can bar parties other than corporations from the usury defense. See *Penrose v. Canton Nat'l Bank*, 147 Md. 200, 127 A. 852 (1925); *MacQuoid v. Queens Estates*, 143 App. Div. 134, 127 N.Y.S. 867 (1911) (minority shareholders in the borrowing corporation); *Houghten v. Restland Memorial Park, Inc.*, 343 Pa. 625, 23 A.2d 497 (1942) (the corporation's receiver

Increasing use of accounts receivable financing has caused the abolition of interest limitations on loans obtained from commercial factors by corporations organized for profit.<sup>44</sup> These loans must be secured by interests in accounts receivable or certain other tangible or intangible personal property. This particular provision, while commercially desirable, is exemplary of the irrational, piecemeal approach taken to interest regulation. There is nothing distinctive about the factoring situation qualifying it for treatment different from that accorded any business financing arrangement. Furthermore, there is little that is distinctive about the corporate borrower in general that should entitle it to borrow at higher interest rates than can the individual businessman. The corporation may be a corner grocery store while the individual may own or control assets totaling millions. Distinctions should be drawn as to the borrower's bargaining power rather than as to the form of his business organization.

The corporate exception has not been reviewed by any North Carolina court to date. Decisions from other jurisdictions, however, indicate that there is likely to be controversy over use of the corporate veil solely to avoid the usury law.<sup>45</sup> The question is whether an individual can legitimately create a corporation with no immediate purpose other than payment of higher interest rates. There are two divergent views of this problem. New York courts have held that a corporation is by its nature a matter of form to be adopted for the purpose of obtaining certain legal advantages.<sup>46</sup> As an individual may incorporate his assets to obtain limited liability, so may he incorporate to avoid the usury laws. New Jersey courts, rejecting this view, have indicated that a case-by-case determination must be made, the crucial factor being the lender's participation in the incorporation.<sup>47</sup> The New Jersey decisions indicate concern that the lender may use the corporate exception to take advantage of consumers<sup>48</sup> and small businessmen. North Carolina's courts, if faced with

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or trustee in bankruptcy). See Comment, *Usury Laws and the Corporate Exception*, 23 MD. L. REV. 51 (1962).

<sup>44</sup> N.C. GEN. STAT. § 24-9 (1965). "Commercial factor" is defined as any corporation or partnership engaging, in the regular course of its business, in the non-recourse, notification purchase of accounts receivable.

<sup>45</sup> See generally Comment, *Incorporation to Avoid the Usury Laws*, 68 COLUM. L. REV. 1390 (1968).

<sup>46</sup> E.g., *Werger v. Haines Corp.*, 302 N.Y. 930, 100 N.E.2d 189 (1951); *Jenkins v. Morse*, 254 N.Y. 319, 172 N.E. 521 (1930).

<sup>47</sup> E.g., *Gelber v. Kugel's Tavern, Inc.*, 10 N.J. 191, 89 A.2d 654 (1952).

<sup>48</sup> Indeed, this has been the case in New York, where legislation to prevent use by lenders of the corporate exception for incorporated private homes has been necessary. See N.Y. GEN. BUS. LAW § 374 (McKinney 1968).

the question, will probably follow the latter view; for, where a corporation serves merely as "a shield for . . . activities in violation of the declared public policy or statute of the state, the corporate entity will be disregarded . . . ."<sup>49</sup> The declared public policy of North Carolina's usury law is to protect the necessitous borrower. Since the corporate exception is based in theory upon the need for higher interest rates in business financing, it should not be available in a consumer context. Should a corporation be formed to carry on a bona fide business, the corporate entity will probably be respected by the courts although its prime immediate purpose be to obtain credit at rates above six percent per annum. Where, however, the corporation serves only as a subterfuge for evasion of the usury laws, North Carolina courts will undoubtedly look upon the individual behind the corporation as the true borrower.

### *Other Exceptions*

The statutory rate of interest for loans made by co-operative credit unions is one percent per month, which may be computed upon the whole principal for the entire term of an installment loan and deducted in advance.<sup>50</sup> Except for a membership fee, the credit union can receive no other consideration for the loan. The effective simple annual interest rate for such a loan payable in installments is approximately 25.1 percent. Exemption for co-operatives is presumably allowed because borrower-members will be vigilant in controlling interest rates.

Another co-operative organization, the agricultural credit corporation, can charge for agricultural loans up to eight percent per annum or three percent per annum in excess of the rediscount rate charged it by federal intermediate credit banks.<sup>51</sup> This exception is also applicable to the Production Credit Associations, which account for a large part<sup>52</sup> of total farm credit. Since P.C.A. loans normally bear lower rates than the market generally for similarly situated borrowers, they have the effect of driving down the cost of agricultural loans generally. In 1967-68 the P.C.A.'s were charging seven to eight percent per annum. If a government-sponsored farmer co-operative must charge such rates, surely a six percent rate limit is unrealistic for the credit market as a whole.

Loans insured by the Federal Housing Administration or the Veterans

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<sup>49</sup> *Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 260, 160 S.E.2d 39, 44 (1968).

<sup>50</sup> N.C. GEN. STAT. § 54-88 (1965).

<sup>51</sup> N.C. GEN. STAT. § 54-89 (1965).

<sup>52</sup> For a discussion of usury and farm credit, see Benfield 865.

Administration, but made by private lenders, are wholly removed from statutory interest regulation.<sup>53</sup> FHA and VA lenders are closely supervised by their insuring federal agencies, thus minimizing the possibility of improper interest practices. This exception was enacted in 1935 at the behest of the Federal Housing Administration to insure uniform treatment of FHA loans.<sup>54</sup>

### *National Banks*

Under federal statute,<sup>55</sup> a national bank can charge interest at the rates allowed by the jurisdiction<sup>56</sup> wherein it is located or at a rate of one percent per annum in excess of the discount rate charged by its particular branch of the federal reserve bank on ninety-day commercial paper. The legal remedies allowed for a usurious transaction are the same as those under the North Carolina usury statute, which is patterned after the federal act.<sup>57</sup>

### *Criminal Sanctions*

The only criminal penalty exclusively for a usury violation is imposed for reserving more than six percent interest upon a loan secured by household or kitchen furniture or by an assignment of wages.<sup>58</sup> The statute has been revised recently in order to bring conditional sales within its purview. This apparently creates a small inroad into the "time price" doctrine discussed below. It may, therefore, prove an effective deterrent against unconscionable credit sale schemes aimed at the poor. Any deterrent value depends upon its use by legal aid agencies and others engaged in the practice of poverty law. Although the law was initially enacted in 1907, there is only one reported case dealing with its provisions.<sup>59</sup>

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<sup>53</sup> N.C. GEN. STAT. § 53-45(e) (1965).

<sup>54</sup> See Poyner, *Some Practical Aspects of the North Carolina Law of Usury*, 12 N.C. BAR NOTES 3, 7 (1960).

<sup>55</sup> 12 U.S.C. § 85 (1964).

<sup>56</sup> As to the application of state usury law to national banks, see generally Annot., 101 A.L.R. 750 (1936). Since national banks are created by federal law to facilitate interstate commerce, state law cannot interfere with their operations by setting interest rates. Maximum rates for national banks can be set only by federal statute. *Farmers' & Mechanics' Nat'l Bank v. Dearing*, 91 U.S. 29 (1875); *Oldham v. First Nat'l Bank*, 85 N.C. 240 (1881).

<sup>57</sup> Compare 12 U.S.C. § 86 (1964) with N.C. GEN. STAT. § 24-2 (1965).

<sup>58</sup> N.C. GEN. STAT. § 14-391 (1965). A violation is a misdemeanor. N.C. GEN. STAT. § 53-166 (1965) imposes criminal penalties for any violation of the Consumer Finance Act. N.C. GEN. STAT. § 53-164 (1965) exempts lenders licensed under the Consumer Finance Act from N.C. GEN. STAT. § 14-391 (1965) penalties.

<sup>59</sup> *State v. Davis*, 157 N.C. 648, 73 S.E. 130 (1911).

## THE FOUR COMMANDMENTS

"The words of the [usury] statutes are general and the decisions of the courts are largely based not on interpretation of specific words but on doctrines developed by the courts in regard to usury which form in a sense a kind of common law in regard to the subject . . . ." <sup>60</sup> This "common law," which has developed around a purely statutory <sup>61</sup> creature, establishes four widely accepted "constituents of usury": <sup>62</sup>

(1) A loan or forbearance of money; (2) an understanding that the money loaned shall be returned; (3) payment or agreement to pay a greater rate of interest than that allowed by law; and (4) a corrupt intent to take more than the legal rate for the use of the money. <sup>63</sup>

In order to establish the usurious nature of a transaction, the borrower must affirmatively plead <sup>64</sup> and prove <sup>65</sup> each <sup>66</sup> of these elements. He must establish by a preponderance of the evidence that, in substance, the transaction was a loan for which the lender intentionally exacted illegal interest. <sup>67</sup> Parol evidence is admissible to show the true nature of the deal-

<sup>60</sup> RESTATEMENT OF CONTRACTS § 526, Introductory Note (1932).

<sup>61</sup> *Virginia Trust Co. v. Lambeth Realty Corp.*, 215 N.C. 526, 2 S.E.2d 544 (1939).

<sup>62</sup> These four elements were formulated by treatise writers and have been widely adopted by the courts. *E.g.*, J. WEBB, *THE LAW OF USURY* § 18 (1899).

<sup>63</sup> *Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 263, 160 S.E.2d 39, 47 (1968). *See, e.g.*, *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 132 S.E.2d 692 (1963); *Preyer v. Parker*, 257 N.C. 440, 125 S.E.2d 916 (1962); *Miller v. Dunn*, 188 N.C. 397, 124 S.E. 746 (1924); *Ector v. Osborne*, 179 N.C. 667, 103 S.E. 388 (1920); *Planters Nat'l Bank v. Wysong & Miles Co.*, 177 N.C. 380, 99 S.E. 199 (1919); *Swamp Loan & Trust Co. v. Yokley*, 174 N.C. 573, 94 S.E. 102 (1917); *Monk v. Goldstein*, 172 N.C. 516, 90 S.E. 519 (1916).

<sup>64</sup> *Michigan Nat'l Bank v. Hanner*, 268 N.C. 668, 151 S.E.2d 579 (1966) (pleadings failed to allege a loan); *Dixon v. Osborne*, 204 N.C. 480, 168 S.E. 683 (1933); *Berger v. Stevens*, 197 N.C. 234, 148 S.E. 244 (1929) (usury may not be raised by demurrer, but must be affirmatively pleaded); *Rountree v. Brinson*, 98 N.C. 107, 3 S.E. 747 (1887).

<sup>65</sup> "[T]he burden of proof is on the party claiming [the transaction] to be usury . . ." *Monk v. Goldstein*, 172 N.C. 516, 518, 90 S.E. 519, 521 (1916). *See also Perry v. Doub*, 249 N.C. 322, 106 S.E.2d 582 (1959) (plaintiff failed to carry the burden of proof).

<sup>66</sup> "[U]nless these four things concur in every transaction it is safe to say that no case of usury can be declared." *Doster v. English*, 152 N.C. 339, 341, 67 S.E. 754, 756 (1910).

<sup>67</sup> A profit, greater than the lawful rate of interest, intentionally exacted as a bonus for the loan of money, imposed upon the necessities of the borrower in a transaction where the treaty is for a loan and the money is to be returned in all events, is a violation of the usury laws, it matters not what form or disguise it may assume.

*Id.* at 341, 67 S.E. at 756.

ings, even though the written indicia of debt recite interest at a legal rate.<sup>68</sup> Where there is no material dispute as to the facts, the court may declare a transaction usurious as a matter of law.<sup>69</sup> Otherwise, the existence of usury is determined by the jury.<sup>70</sup> If the first three elements are apparent upon the face of the contract, corrupt intent will be implied;<sup>71</sup> if not, the party asserting usury must introduce evidence to establish the lender's state of mind.<sup>72</sup> The necessary intent is found "in the charging or receiving the excessive interest with the knowledge that it is prohibited by law, and the purpose to violate it."<sup>73</sup> The subjective nature of an intent determination demands that reasonable inferences be drawn from more objective facts. Thus, as a practical matter, it is not difficult to establish intent<sup>74</sup> in a civil action involving usury where the loan and the illegal interest are clearly proved.

If the elements of a usurious transaction are present, the borrower has two possible legal remedies.<sup>75</sup> Where the borrower has in fact paid money or its equivalent as usurious interest,<sup>76</sup> he can recover as a penalty

<sup>68</sup> *Ridley v. Jim Walter Corp.*, 272 N.C. 673, 158 S.E.2d 869 (1968).

<sup>69</sup> *Doster v. English*, 152 N.C. 339, 67 S.E. 754 (1910).

<sup>70</sup> *Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 160 S.E.2d 39 (1968); *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 132 S.E.2d 692 (1963); *Monk v. Goldstein*, 172 N.C. 516, 90 S.E. 519 (1916). For decisions as to the sufficiency of the evidence to support a jury verdict, see *Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 160 S.E.2d 39 (1968); *White v. Disher*, 232 N.C. 260, 59 S.E.2d 798 (1950).

<sup>71</sup> *Planters Nat'l Bank v. Wysong & Miles Co.*, 177 N.C. 380, 99 S.E. 199 (1919); *MacRackan v. Bank of Columbus*, 164 N.C. 24, 80 S.E. 184 (1913); *Charles S. Riley & Co. v. W.T. Sears & Co.*, 154 N.C. 509, 70 S.E. 997 (1911).

<sup>72</sup> For a case where parol evidence in the form of testimony by the parties and their attorneys was allowed to show their intentions, see *Doster v. English*, 152 N.C. 339, 67 S.E. 754 (1910). See also *Perry v. Doub*, 249 N.C. 322, 106 S.E.2d 582 (1959) (plaintiff failed to prove intent).

<sup>73</sup> *MacRackan v. Bank of Columbus*, 164 N.C. 24, 26, 80 S.E. 184, 185 (1913). See *Ector v. Osborne*, 179 N.C. 667, 103 S.E. 388 (1920); *Bennett v. Best*, 142 N.C. 168, 55 S.E. 84 (1906); N.C. GEN. STAT. § 24-2 (1964) requires that usurious interest be "knowingly" exacted. But cf. *Ehringhaus v. Ford*, 25 N.C. 522 (1843) (construing ante-bellum statute and holding no intent to violate law necessary). The intent requirement also is important in determining whether a purportedly exempt transaction is in fact a subterfuge for evasion of usury laws. See discussion of avoidance and evasion, *infra*.

<sup>74</sup> In a usury action, intent is a question of fact to be determined by the jury. *Yarborough v. Hughes*, 139 N.C. 199, 208, 51 S.E. 904, 907 (1905).

<sup>75</sup> The rights granted by N.C. GEN. STAT. § 24-2 (1965) may be asserted by the borrower even though he importuned the lender to lend to him at illicit rates and is considered *in pari delicto* with the lender. *MacRackan v. Bank of Columbus*, 164 N.C. 24, 80 S.E. 184 (1913).

<sup>76</sup> *Rushing v. Bivens*, 132 N.C. 273, 43 S.E. 798 (1903). Merely giving or renewing a note for interest does not constitute payment. *Ragan v. Stephens*, 178 N.C. 101, 100 S.E. 196 (1919).

an amount equal to twice the entire interest paid by him.<sup>77</sup> In any event, because the usury violation works a complete forfeiture<sup>78</sup> of all the interest charged, the borrower can successfully defend any action brought by the lender to collect the interest. These remedies are wholly distinct and must be separately asserted.<sup>79</sup> The penalty may be obtained in an action by the borrower in the nature of an action for debt, or it may be recovered on a counterclaim<sup>80</sup> in the lender's action to collect principal or interest. The terms of the statute limit the recovery that may be had and constitute the exclusive legal remedy for a usurious transaction.<sup>81</sup> An action for the penalty is barred by the statute of limitations upon the lapse of two years from the date of payment.<sup>82</sup> No statute of limitations runs against the forfeiture defense, which may be asserted whenever the lender brings an action for the interest.<sup>83</sup>

The borrower also has an equitable remedy<sup>84</sup> under certain circumstances. Where the lender holds a security interest in real or personal property as a result of usurious dealings, the debtor or other person with an interest<sup>85</sup> in the security property can obtain affirmative equitable relief

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<sup>77</sup> *Taylor v. Parker*, 137 N.C. 418, 49 S.E. 921 (1905).

<sup>78</sup> When usury is charged, the debt becomes simply a loan bearing no interest, and the debtor is entitled to have all his payments credited to principal. *Ervin v. First Nat'l Bank*, 161 N.C. 42, 76 S.E. 529 (1912). See also, as to the nature of the statutory remedies, *Guaranty Bond & Mortgage Co. v. Fair Promise A.M.E. Zion Church*, 219 N.C. 395, 14 S.E.2d 37 (1941); *Ripple v. Mortgage & Accept. Corp.*, 193 N.C. 422, 137 S.E. 156 (1927).

<sup>79</sup> Where the penalty is sought, the time and amount of payment must be alleged with specificity if the information is known or obtainable. *Charles S. Riley & Co. v. W.T. Sears & Co.*, 154 N.C. 509, 70 S.E. 997 (1911).

<sup>80</sup> N.C. GEN. STAT. § 24-2 (1965). This counterclaim is properly brought only in an action for debt commenced by the lender and based upon the usurious transaction or some other transaction between the parties. *Commercial Credit Corp. v. Robeson Motors*, 243 N.C. 326, 90 S.E.2d 886 (1956). It may not be brought in a tort action, *Commercial Fin. Co. v. Holder*, 235 N.C. 96, 68 S.E.2d 794 (1952), or an ejectment action, *North Carolina Mortgage Corp. v. Wilson*, 205 N.C. 493, 171 S.E. 783 (1933).

<sup>81</sup> *Auto Fin. Co. v. Simmons*, 247 N.C. 724, 102 S.E.2d 119 (1958) (borrower unsuccessfully alleged the same facts for usury and fraud causes of action).

<sup>82</sup> N.C. GEN. STAT. § 1-53 (1953). The cause of action for the penalty accrues upon the date of payment. The statute does not run during a period of non-residence by the lender or his agent. *Ghormley v. Hyatt*, 208 N.C. 478, 181 S.E. 242 (1935); *Farmer's Bank & Trust Co. v. Redwine*, 204 N.C. 125, 167 S.E. 687 (1933); *Cuthbertson v. Peoples Bank*, 170 N.C. 531, 87 S.E. 333 (1915).

<sup>83</sup> *Pugh v. Scarboro*, 200 N.C. 59, 156 S.E. 149 (1930).

<sup>84</sup> N.C. GEN. STAT. § 24-2 (1965).

<sup>85</sup> A junior mortgage has been held to have sufficient interest. *Pinnix v. Maryland Cas. Co.*, 214 N.C. 760, 200 S.E. 874 (1939). Presumably, under the language of N.C. GEN. STAT. § 24-2 (1965), any recognized property interest would be sufficient.

to prevent foreclosure until final determination of the parties' liabilities. Prior to statutory recognition<sup>86</sup> of the remedy, the debtor was required to "do equity" by tendering the principal plus interest at the legal rate to the lender before he could seek equitable relief.<sup>87</sup> When he did obtain equitable relief he also denied himself any remedy under the usury statute.<sup>88</sup> N.C. GEN. STAT. § 24-2 (1964) has been amended to change these rules by explicitly negating the tender requirement, which had denied equitable relief to the impecunious borrower, and by explicitly entitling the borrower to both equitable and statutory remedies.

Remedies available under the usury statute are personal to the borrower<sup>89</sup> and his legal representatives.<sup>90</sup> Since these remedies were enacted for the benefit of the borrower, he can waive the right to rely on them under certain narrowly defined circumstances. Where a controversy has arisen about a usurious contract and the debtor has entered into a compromise or a general settlement as to the transaction, his recognition of an obligation under the settlement will preclude his setting up the old transaction in defense of the new debt. The settlement must have been arrived at fairly and without circumstances of imposition. It must constitute a just debt in the nature of a novation rather than a mere renewal of the prior debt.<sup>91</sup> Under no other circumstances can a borrower waive his rights under the statute. Neither the borrower's prior consent to usury nor his subsequent approval of it constitutes waiver.<sup>92</sup>

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<sup>86</sup> Ch. 110 [1959] N.C. Sess. L.

<sup>87</sup> "Where a debtor seeks the aid of a court of equity on the ground his debt is tainted with usury, he may have the usurious element . . . eliminated from his debt only upon his paying the principal of his debt with interest at the legal rate. [H]e is not entitled to the benefit of the statutory penalties for usury." *Bailey v. Inman*, 224 N.C. 571, 573-74, 31 S.E.2d 769, 770 (1944). See, e.g., *Pinnix v. Maryland Cas. Co.*, 214 N.C. 760, 200 S.E. 874 (1939); *Buchanan v. Carolina Mortgage Co.*, 213 N.C. 247, 195 S.E. 787 (1938); *Miller v. Dunn*, 188 N.C. 397, 124 S.E. 746 (1924). But cf. *Churchill v. Turnage*, 122 N.C. 426, 30 S.E. 122, 123 (1898) (Clark, J., dissenting). Judge Clark argued that the tender requirement had validity only during the period when the harsh statutory remedy was forfeiture of the principal, and that it should be abandoned under the newer statute.

<sup>88</sup> *Waters v. Garriss*, 188 N.C. 305, 124 S.E. 334 (1924).

<sup>89</sup> E.g., *Virginia Trust Co. v. Lambeth Realty Corp.*, 215 N.C. 526, 2 S.E.2d 544 (1939).

<sup>90</sup> "Legal representative" includes trustee in bankruptcy, receiver, and executor. *Ripple v. Mortgage & Accept. Corp.*, 193 N.C. 422, 137 S.E. 156 (1927); *Charles S. Riley & Co. v. W.T. Sears & Co.*, 154 N.C. 509, 70 S.E. 997 (1911).

<sup>91</sup> *Hill v. Lindsay*, 210 N.C. 694, 188 S.E. 406 (1936). See *Ghormley v. Hyatt*, 208 N.C. 478, 181 S.E. 242 (1935); *Dixon v. Osborne*, 204 N.C. 480, 168 S.E. 683 (1933); *Miller v. Dunn*, 188 N.C. 397, 124 S.E. 746 (1924); *Ector v. Osborne*, 179 N.C. 667, 103 S.E. 388 (1920).

<sup>92</sup> *MacRackan v. Bank of Columbus*, 164 N.C. 24, 80 S.E. 184 (1913). Where



Forfeiture of all interest under the usury statute renders an agreement as to interest null and void ab initio. Therefore, usury is a real defense<sup>93</sup> against a holder in due course<sup>94</sup> to the extent that an instrument represents interest on a usurious transaction.<sup>95</sup> This rule is intended to preserve the integrity of the usury prohibition where the lender seeks to evade forfeiture by negotiating an obligation to an innocent purchaser. It should be noted that the holder has recourse to the indorsers of the instrument for breach of their contractual obligations.<sup>96</sup>

### IS IT USURY?

Where a transaction is in reality a loan of money, whatever may be its form, and the lender charges for the use of his money a sum in excess of interest at the legal rate, by whatever name the charge may be called, the transaction will be held to be usurious. The law considers the substance and not the mere form or outward appearance of the transaction in order to determine what it in reality is. If this were not so, the usury laws of the State would easily be evaded by lenders of money who would exact from borrowers with impunity compensation for money loaned in excess of interest at the legal rate.<sup>97</sup>

The tone of this classic admonition by the North Carolina Supreme Court indicates that the lender who structures a transaction with the purpose of avoiding the usury laws has perforce failed at the outset.<sup>98</sup> By no means is this always the case. The court, faced with the verity that credit will not be available at legal rates when legal rates are not

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the debtor executed a new note and a release that purported to bar its usury claims, there was no effective waiver because the debtor was forced to pay part of the usury to obtain further financing. *Guaranty Bond & Mortgage Co. v. Fair Promise A.M.E. Zion Church*, 219 N.C. 395, 14 S.E.2d 37 (1941).

<sup>93</sup> For the effect of a real defense, see N.C. GEN. STAT. § 25-3-305 (1965).

<sup>94</sup> A holder in due course takes the instrument for value, in good faith, and without notice of any defense against it. N.C. GEN. STAT. § 25-3-302 (1965).

<sup>95</sup> *Federal Reserve Bank v. Jones*, 205 N.C. 648, 172 S.E. 185 (1934); *Faison v. Grandy & Sons*, 126 N.C. 827, 36 S.E. 276 (1900); *Ward v. Sugg*, 113 N.C. 489, 18 S.E. 717 (1893). See also *Auto Fin. Co. v. Simmons*, 247 N.C. 724, 102 S.E.2d 119 (1958).

<sup>96</sup> N.C. GEN. STAT. § 25-3-414 (1965).

<sup>97</sup> *Ripple v. Mortgage & Accept. Corp.*, 193 N.C. 422, 137 S.E. 156 (1927). See, e.g., *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 132 S.E.2d 692 (1963); *Pratt v. American Bond & Mortgage Co.*, 196 N.C. 294, 145 S.E. 396 (1928); *English Lumber Co. v. Wachovia Bank & Trust Co.*, 179 N.C. 211, 102 S.E. 205 (1920); *Monk v. Goldstein*, 172 N.C. 516, 90 S.E. 519 (1916); *Charles S. Riley & Co. v. W. T. Sears & Co.*, 154 N.C. 509, 70 S.E. 997 (1911).

<sup>98</sup> A credit transaction will be adjudged usurious "according to its substance and its necessary tendency and effect, when the purpose and intent of the lender are unmistakable." *Planters Nat'l Bank v. Wysong & Miles Co.*, 177 N.C. 380, 388, 99 S.E. 199, 204 (1919).

profitable, has created within the credit market various sanctuaries from the usury laws. It has defined these sanctuaries by deciding that a given transaction is not in reality a loan of money or that a given payment is not in reality interest.<sup>99</sup> However, not all avoidance devices proffered by the parties to credit dealings have been successful. A survey of the cases will demonstrate that there exist no simple, infallible abstractions that, when applied to a contract, will indicate whether any part of it will be subjected to the usury laws. Rather, it is necessary to look to the treatment received in the past by that particular species of contract.<sup>100</sup>

### *The Time Price Doctrine*

A sale on credit is not a loan of money and is therefore not governed by the usury statutes.<sup>101</sup> A seller, because he is free to ask any price for his goods, may set a cash price and an alternative, higher time price. If the buyer elects the latter, the added amount paid for the seller's forbearance is not interest, but merely a price increment. This "time price"<sup>102</sup> doctrine draws a wholly artificial distinction between the credit sale and the loan, both of which have the same economic effect. There is no real difference between borrowing one hundred dollars at approximately forty percent simple annual interest to purchase an item and purchasing

<sup>99</sup> In *Associated Stores, Inc. v. Industrial Loan & Inv. Co.*, 202 F. Supp. 251 (E.D.N.C. 1962) (Craven, J.), the North Carolina usury law was held applicable to the facts before the court: "The *shorthand way* of expressing this conclusion is to call it a loan transaction . . ." *Id.* at 253 (emphasis added). For an example of the North Carolina Supreme Court's deft avoidance of a usury problem, see *Preyer v. Parker*, 257 N.C. 440, 125 S.E.2d 916 (1962). In a timberland sale transaction, the defendant had executed a contract saying "[f]or the use of the thirty-five thousand dollars received from you I will repay thirty-five thousand dollars plus seventeen thousand five hundred dollars at the time of sale of this timber." The court held that there was no loan, but that the plaintiffs had paid thirty-five thousand dollars for an option to purchase land with seventeen thousand five hundred dollars to serve as liquidated damages if the defendant failed to honor the option. Neither party had argued the option theory. The transaction was purely business and potentially involved 1.6 million dollars; therefore, as a matter of policy, the result was correct.

<sup>100</sup> For discussions as to the common means of avoidance and evasion of the usury laws, see generally Shanks, *supra* note 5; Prather, *Mortgage Loans and the Usury Laws*, 16 BUS. LAW. 181 (1960); Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 54 (1941).

<sup>101</sup> The time price doctrine was established in *Beete v. Bidgood*, 108 Eng. Rep. 792 (K.B. 1891), and first appeared in the United States in *Mitchell v. Griffith*, 22 Mo. 515 (1856). See generally Comment, *Retail Credit Sales and Usury*, 24 LA. L. REV. 822 (1964).

<sup>102</sup> See generally Note, *Judicial and Legislative Treatment of "Usurious" Credit Sales*, 71 HARV. L. REV. 1143 (1958).

the same item for one hundred twenty dollars payable in twelve "easy monthly payments." Purportedly, the "purchaser is not, like the needy borrower, a victim of a rapacious lender, since he can refrain from the purchase."<sup>103</sup> It would seem that borrowers and purchasers are in fact equally capable of self-restraint.

Recent cases<sup>104</sup> have demonstrated that the "time price" axiom has much vitality in North Carolina where all "bona fide" credit sales are exempted from any supervision of finance charges.<sup>105</sup> A "sale" does not become a "loan" even though the financier to whom the buyer's note is negotiated has solicited business from the seller, furnished all the forms used, and provided a set of tables to be used in computing the "time price differential." Nor does the use of a percentage formula to calculate the differential affect its de jure nature. The discounting of commercial paper to a financier is in itself a sale and thus not subject to the usury laws.<sup>106</sup> But *Ripple v. Mortgage & Acceptance Corp.*<sup>107</sup> indicates that there may be limits to the court's indulgence in allowing credit sales financing without regulation. Where the purchase of a 1924 automobile resulted in over eleven hundred dollars in finance charges and the sale contract named the financier as vendor, the transaction was held to be a colorable attempt to evade the usury laws and thus subject to them. More recent cases distinguish *Ripple* because its holding was based on the contradiction between the contract and the facts regarding the initial locus of title to the automobile. Automobile financiers have since scrupu-

<sup>103</sup> *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 340, 132 S.E.2d 692, 695 (1963).

<sup>104</sup> *Michigan Nat'l Bank v. Hanner*, 268 N.C. 668, 151 S.E.2d 579 (1966), noted in 45 N.C.L. REV. 1151 (1967); *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 132 S.E.2d 692 (1963).

<sup>105</sup> See, e.g., *Dillingham v. Gardner*, 222 N.C. 279, 21 S.E.2d 898 (1942); *Hendrix v. Harry's Cadillac Co.*, 220 N.C. 84, 16 S.E.2d 456 (1941); *Doster v. English*, 152 N.C. 339, 67 S.E. 754 (1910); *Yarborough v. Hughes*, 139 N.C. 199, 51 S.E. 904 (1905). North Carolina has no comprehensive retail sales legislation such as Maryland's Retail Installment Sales Act, MD. ANN. CODE art. 83, § 128 (1957) *et seq.*, which sets limits for finance charges and requires full disclosure of credit terms. N.C. GEN. STAT. § 44-54 (1966), limits the time price differential for the credit sale of certain agricultural supplies to ten percent per annum.

<sup>106</sup> *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 132 S.E.2d 692 (1963). This practice is prevalent in automobile sales where the bank all but sets up a branch on the dealer's premises and total finance charges reach thirty percent per annum. *Charlotte (N.C.)*, Observer, Mar. 5, 1969, § A at 1, col. 1.

<sup>107</sup> 193 N.C. 423, 137 S.E. 156 (1927). See *Monk v. Goldstein*, 172 N.C. 516, 90 S.E. 519 (1916) (usury found where "buyer" first approached the financier for a loan whereupon financier purchased the automobile and "sold" it to buyer for a high time price).

lously avoided this pitfall. The cases continue to state, nevertheless, that substance controls form in determining the nature of credit dealings, thereby leaving open the possibility that the usury statutes will be applied to time price sales that exhibit too many loan characteristics.<sup>108</sup>

The ruling that a time price differential computed by taking a percentage of the cash price does not constitute interest indicates that the same result may obtain as to a "revolving charge plan." Under such a plan,<sup>109</sup> the merchant allows his customer to purchase items on credit with the cash price of each to be debited to the customer's account. Rather than setting a "time price" for each item, the merchant exacts a 1.5 percent per month "service charge" computed upon any balance outstanding longer than thirty days. Such charges for forbearance of debt are substantially similar to the time price differential, both of which are arrived at by the use of a formula in which the variables are time and the percentage to be charged. In this context, however, credit is directly extended by the vendor rather than by a purchaser of commercial paper, which gives the revolving charge plan a bit more the appearance of a loan than does the tripartite transaction.

Akin to the revolving charge plan is the bank credit card,<sup>110</sup> which also entails a 1.5 percent per month service charge on any balance outstanding more than thirty days. The bank and the cardholder maintain a continuing relationship, as do the bank and participating merchants. When a cardholder purchases an item with his card, he signs a negotiable "sales draft" in which he, as "purchaser-acceptor," agrees to pay to the bank "or order" the amount indicated thereon. This draft is discounted to the bank which debits its amount to the cardholder's account. The tripartite nature of this arrangement renders it closely analogous to the financing situation discussed above in which commercial paper is negotiated to the financier. Thus, the retail sale financing aspect of the bank credit

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<sup>108</sup> Cf. *Hare v. General Contract Purchase Corp.*, 220 Ark. 601, 249 S.W.2d 973 (1952), holding that where the vendor reserves a time price differential with the intention and assurance of transferring the commercial paper to a financier, the usury laws apply. Arkansas has not abandoned its time price doctrine, but has determined that such transactions are subterfuges for usury.

<sup>109</sup> North Carolina has no decisions as to revolving charge plans. Arkansas and Nebraska courts have held that where a percentage rate is applied to a cash price, the differential is paid for forbearance of a debt and is thus limited by the usury laws. *Sloan v. Sears, Roebuck & Co.*, 228 Ark. 664, 308 S.W.2d 802 (1958); *Lloyd v. Gutgsell*, 175 Neb. 775, 124 N.W.2d 198 (1963).

<sup>110</sup> For an interesting discussion by a banker of the ethical problems involved in high finance charges in automobile financing and bank credit cards, see *Raleigh (N.C.) News and Observer*, Feb. 9, 1969, § IV, at 3, col. 5.

card is probably exempt from North Carolina's usury laws. The opposite is true of loans available to the cardholder, which are euphemistically labelled, for example, "instant money." A cardholder presents his card at the bank whereupon he receives the amount of "instant money" requested less a five percent fee. The full amount of the loan is then debited to his account and treated as would be the amount of a purchase made with the card. Should a cardholder seek a two hundred dollar loan, receive one hundred ninety dollars in proceeds, and repay two hundred dollars in twelve equal monthly installments, the effective simple annual interest rate would be approximately 27.2 percent. Such a two party transaction, involving no sale of merchandise, palpably constitutes a loan of money under the usury laws. "Where there is a negotiation for a loan of money, and the borrower agrees to return the amount advanced at all events, it is a contract of lending, and, however the transaction may be shaped or disguised, if a profit or return beyond the legal rate of interest is intended . . . the contract is usurious."<sup>111</sup>

### *The Colorable Sale*

Because sales are not governed by the usury statutes, a ploy commonly used to evade interest limitation is the sale and repurchase.<sup>112</sup> A building contractor in need of financing might sell equipment to a lender for ten thousand dollars with an option to repurchase the equipment in one year for its then fair market value of thirteen thousand dollars. Possession and enjoyment of the equipment remain in the contractor. In economic effect, this "sale" allows the lender a thirty percent per annum return for use of his money as well as a security interest in the equipment. Where funds were borrowed from a corporation and at the closing of the loan such a sale with option to repurchase was made to the corporation's president, the North Carolina Supreme Court held that the usury defense was not available against the corporation because the borrower had failed to prove the sale a quid pro quo for the loan. Nevertheless, the court considered the evidence sufficient to sustain a finding that the "sale" was a usurious subterfuge and stated that the usury defense would be available in an action by the president for possession of the equipment "sold."<sup>113</sup>

<sup>111</sup> *MacRackan v. Bank of Columbus*, 164 N.C. 24, 26, 80 S.E. 184, 185 (1913).

<sup>112</sup> *Collins, Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 54, 64 (1941).

<sup>113</sup> *Sledge Lumber Corp. v. Southern Builders Equip. Co.*, 257 N.C. 435, 126 S.E.2d 97 (1962). "The profit realized [on a sale] even if excessive, would not amount to usury, unless it was a mere device to cover and conceal a usurious transaction." *Yarbrough v. Hughes*, 139 N.C. 199, 207, 51 S.E. 904, 907 (1905). For

Another nominal sale subject to the usury laws is the sale with full recourse. Evidences of debt are normally the items transferred in such a transaction. The "seller" in a recourse sale guarantees that the buyer will, in all events, recoup all the money advanced plus the amount of the discount on the sale.<sup>114</sup> If the guaranteed profit exceeds the legal interest rate, the buyer is guilty of usury. It matters not whether the seller actually has to pay under his recourse obligations so long as the buyer receives a profit in excess of the legal interest rate, for the courts do not distinguish direct payments from indirect profits in this context.<sup>115</sup>

An increasingly popular device that serves the economic purpose of a loan is the "sale and leaseback."<sup>116</sup> Property is sold to a leasing corporation or financier, which then leases it back to the seller at a rental charge calculated to bear a profitable return for the lessor. The lessee gets income tax deductions for rent paid rather than much smaller interest or depreciation deductions and, if the property is equipment, he may receive maintenance service from the lessor. At the end of the lease term, the lessee makes a "balloon" payment in return for full title to the property. As does a secured loan, the sale and leaseback furnishes liquid capital while the initial owner of the property retains its use.<sup>117</sup> Although this scheme may have business purposes other than evasion of the usury laws, the latter purpose normally plays the larger role. In light of the existing case law concerning colorable sales, the North Carolina courts would probably hold the sale and leaseback to be in fact a loan.<sup>118</sup>

### *The Hazard Agreement*

Since one necessary element of a usurious transaction is a fixed obligation to repay the borrowed funds, the terms of a loan contract sometimes

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decisions holding certain transactions which smack of credit dealings to be purely sales, see *Dillingham v. Gardner*, 222 N.C. 79, 21 S.E.2d 898 (1942) (sale of a promissory note); *Doster v. English*, 152 N.C. 339, 67 S.E. 754 (1910) (defendant bought in land for plaintiff at a foreclosure sale and resold it to him at a higher price).

<sup>114</sup> *Associated Stores, Inc. v. Industrial Loan & Inv. Corp.*, 202 F. Supp. 251 (E.D.N.C. 1962); *Sedbury v. Duffy*, 158 N.C. 432, 74 S.E. 3 (1912); *Ballinger v. Edwards*, 39 N.C. 449 (1846).

<sup>115</sup> *Associated Stores, Inc. v. Industrial Loan & Inv. Corp.*, 202 F. Supp. 251 (E.D.N.C. 1962).

<sup>116</sup> See *Shanks* 340-41.

<sup>117</sup> For a decision as to whether a lease creates a security interest for filing purposes under Article 9 of the Uniform Commercial Code, see *In re Transcontinental Indus., Inc.*, 3 U.C.C. Rep. 235 (N.D. Ga. 1965).

<sup>118</sup> For the decisions from other jurisdictions about colorable sales, see cases collected in *Annot.*, 154 A.L.R. 1063 (1945).

specify that it need not be repaid if a certain contingency occurs. Such a device can be successful because of the notion that any payment in excess of the legal interest rate is compensation for the "hazard" that the principal will be lost.<sup>119</sup> The hazard, however, must be a material one. For example, where a lender assumes the full risks of a business venture as to the principal and receives no guarantee that it will otherwise be repaid, a share of the profits is not usurious though the return exceeds licit interest rates. If the contingency be merely nominal, with no real hazard to the principal,<sup>120</sup> as where repayment is predicated on the existence of a certain parcel of land at the date due, the usury laws apply.

### *Discounting and Add-on Interest*

As noted in the discussion of North Carolina statutes above, the "discounting," or deducting, of maximum legal interest in advance is allowed only for certain lenders. For example, the borrower executes a note for two hundred dollars and receives one hundred ninety dollars although he asked to borrow two hundred dollars. This practice is also known as charging "add-on" interest: the borrower asks for and receives two hundred dollars, but he executes a note for two hundred ten dollars. The common law rule is that the discounted note is usurious if the effective rate, computed upon the proceeds actually received, is excessive, regardless of the stated rate of interest.<sup>121</sup> Nevertheless, "interest by way of discount may be taken in advance for short periods" up to one year in length even though the maximum legal interest be deducted.<sup>122</sup>

Chattel paper is an article of commerce that can be sold; therefore, its sale at a discount is not subject to the North Carolina usury laws. Such discounting must, of course, be a "true" sale and not part of a subterfuge to evade interest limitations.<sup>123</sup>

### *Bona Fide Error and the De Minimis Doctrine*

A slight error by the lender, in calculation or otherwise, that causes the interest reserved or paid to exceed the allowable rate is not generally viewed as sufficient to invoke usury penalties. One reason is that a very small error does not evidence intent to take usury; another is that the

<sup>119</sup> Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 54, 62 (1941).

<sup>120</sup> *Charles S. Riley & Co. v. W.T. Sears & Co.*, 154 N.C. 509, 70 S.E. 997 (1911).

<sup>121</sup> Shanks 337. There are no North Carolina cases directly in point.

<sup>122</sup> *Crowell v. Jones*, 167 N.C. 386, 83 S.E. 551, 552 (1914).

<sup>123</sup> See cases cited note 106 *supra*.

courts are loath to hear insignificant controversies.<sup>124</sup> A North Carolina decision held an allegation of payment received by mistake to be insufficient to raise the usury issue.<sup>125</sup> Furthermore, the taking or exacting of excessive interest must be done intentionally and "not by mere error of calculation."<sup>126</sup> Considering the rule that corrupt intent can be implied as a matter of law where usury appears on the face of the contract,<sup>127</sup> a usurious increment that is more than slight would not be a "bona fide" error. It would, therefore, be violative of the usury statute.

### *Fees and Other Financing Charges*

Fees charged the borrower as reimbursement for expenses actually incurred and services actually rendered by the lender incidental to making the loan are not generally held to be interest. These fees must not be excessive, nor may they be charged with intent to evade interest limitations. They must be bona fide charges that are reasonable in relation to the amount of the loan<sup>128</sup> and to the nature of the collateral. Fees that are clearly unreasonable will probably give rise to an implication as a matter of law that usury was intended.<sup>129</sup> Examination of title to and appraisal of collateral cause most of the costs properly chargeable to the borrower. The borrower may also be charged for drafting and recording documents necessary for closing the loan.<sup>130</sup> Ordinary overhead expenses incurred by the lender in the course of its business cannot be passed along to the borrower.<sup>131</sup>

There is little North Carolina authority regarding such fees. An early case held that a small charge in excess of the legal interest rate for the lender's travel expenses did not taint the transaction with usury.<sup>132</sup> In 1895, the court held that an undertaking by the borrower to pay the lender's attorney's fee resulting from default or foreclosure rendered the contract usurious. By way of dictum, the court added that this holding did not require the lender to bear all costs incident to the loan or foreclosure.<sup>133</sup>

<sup>124</sup> Prather, *Mortgage Loans and the Usury Laws*, 16 BUS. LAW. 181, 196 (1960).

<sup>125</sup> Gillam v. Life Ins. Co., 121 N.C. 369, 28 S.E. 470 (1897).

<sup>126</sup> Ward v. Sugg, 113 N.C. 489, 494, 18 S.E. 717, 720 (1893).

<sup>127</sup> See cases cited note 71 *supra*.

<sup>128</sup> See cases collected in Annot., 105 A.L.R. 795 (1936); Annot., 63 A.L.R. 823 (1929); Annot., 21 A.L.R. 797 (1922); see Note, 10 N.C.L. REV. 403 (1932).

<sup>129</sup> See cases cited note 71 *supra*.

<sup>130</sup> Annot., 21 A.L.R. 797, 871-75 (1922).

<sup>131</sup> *Id.*

<sup>132</sup> Massey, McKesson & Co. v. McDowell, 20 N.C. 252 (1838).

<sup>133</sup> Williams v. Rich, 117 N.C. 235, 23 S.E. 257 (1895).



Disallowance of the attorney's fee should not be taken as indicative of the court's attitude toward bona fide fees in general.<sup>134</sup> Although partially founded upon the usury concept, it largely results from a legal antipathy toward any penalty levied against the debtor upon default.<sup>135</sup>

The North Carolina court has implicitly recognized the validity of reasonable incidental expenses chargeable to the borrower. It characterized use of the contract term "items of expense," without more specificity, to describe charges in excess of the licit rate as "strongly indicative of usurious evasion." Determination of whether these fees were in fact usurious was left to the jury,<sup>136</sup> which could presumably find them to be legitimate non-interest payments.

Where the lender exacts charges that are not in fact reimbursement for expense incurred or services rendered, North Carolina's usury statute has been held to apply.<sup>137</sup> "[A]ny charges made against [the borrower] in excess of the lawful rate of interest, whether called fines, charges, dues or interest are, in fact, interest and usurious."<sup>138</sup> Attempts to evade the usury laws through euphemism are myriad. Nevertheless, the point, the bonus, the loan fee, the placement fee, the loan commission, the brokerage fee and any other charge that inures to the benefit of the lender as compensation solely for making a loan are all generally treated as interest.<sup>139</sup> The ubiquitous point system is an excellent example. It requires that the borrower pay a bonus to the lender merely because the lender has consented to the loan. Each point is one percent of the loan principal. The calculation of points payable often bears little relationship to the term of the loan; thus, the shorter the term, the higher the effective interest rate. A "bonus" is defined as something paid to the lender in addition to what

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<sup>134</sup> See, e.g., *Turner v. Boger*, 126 N.C. 300, 35 S.E. 592 (1900).

<sup>135</sup> E.g., *Security Fin. Co. v. Hendry*, 189 N.C. 549, 127 S.E. 629 (1925). The rule is part of a policy against allowing counsel fees as part of the costs awarded with recovery on an action. See *Wachovia Bank & Trust Co. v. Schneider*, 235 N.C. 446, 70 S.E.2d 578 (1952).

<sup>136</sup> *Jonas v. Home Mortgage Co.*, 205 N.C. 89, 170 S.E. 127 (1933).

<sup>137</sup> *Hollowell v. Southern Bldg. & Loan Ass'n*, 120 N.C. 286, 26 S.E. 781 (1897). The problem of proof facing the borrower who alleges a fee exacted by an institutional lender to be illicit is formidable unless the charge is grossly excessive. It is impossible to ascertain the actual cost of a collateral service to a large-scale lender without its co-operation.

<sup>138</sup> *Id.* at 287, 26 S.E. at 781. Building and loan association fines and dues have apparently since been excepted from the usury laws by statute. N.C. GEN. STAT. § 54-22 (1965). But cf. *Rowland v. Old Dominion Bldg. & Loan Ass'n*, 116 N.C. 877, 22 S.E. 8 (1895), which contains language indicating that such exemptions would be unconstitutional. See note 17 *supra*.

<sup>139</sup> Shanks 335.

is "strictly due" him.<sup>140</sup> When "points" or other such fees are added to the legal interest rate, the result is "a profit greater than the lawful rate of interest, intentionally exacted as a bonus for the loan of money."<sup>141</sup>

Certain other payments to the lender are also normally excepted from the general rule as to fees because they are made in consideration of some undertaking or concession on the part of the lender; *i.e.*, they are not consideration for the use of money. The lender may promise that future advances will be available when needed, whereupon the borrower pays a commitment fee in return. This amounts to a purchase and sale of the right to borrow money in the future.<sup>142</sup> There is no reason to expect North Carolina courts to treat the commitment fee as usurious so long as it be found in a bona fide setting. Such fees are most often used in the construction industry where obligatory future financing is a necessity. It should be noted that the statute explicitly authorizing limited fees to be charged by certain lenders provides that "no charge shall be collected unless a loan shall have been made."<sup>143</sup> This language may bar the retention by those lenders of a commitment fee where future advances are not in fact made.

When the borrower voluntarily chooses to repay a loan before its maturity, he is frequently required by contract to pay a prepayment premium. Most courts treat the premium as a charge for the privilege of prematurely discharging the debt and not as interest.<sup>144</sup> The North Carolina Supreme Court has faced the question squarely and ruled that the privilege of prepaying a loan at a time advantageous to the borrower can only be exercised by compensating the lender for the trouble he would incur thereby and for the loss he would probably sustain from falling interest rates.<sup>145</sup> Prepayment is naturally most attractive to the borrower in a falling credit market. In the instant case a ten percent prepayment premium was validated. The court emphasized that the borrower was under no duress<sup>146</sup> to pay the premium and had contracted for the privilege to prepay.

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<sup>140</sup> Pugh v. Scarboro, 200 N.C. 59, 62, 156 S.E. 149, 150 (1930).

<sup>141</sup> Doster v. English, 152 N.C. 339, 341, 67 S.E. 754, 755 (1910).

<sup>142</sup> Prather, *Mortgage Loans and the Usury Laws*, 16 BUS. LAW. 181 (1960).

<sup>143</sup> N.C. GEN. STAT. § 53-141(3) (1965).

<sup>144</sup> See Comment, *Usury—Prepayment Options—Interest on Voluntary Prepayment Before Maturity Not Usurious Though Above the Maximum Rate for the Year*, 14 WAYNE L. REV. 712 (1968).

<sup>145</sup> Bell Bakeries, Inc. v. Jefferson Standard Life Ins. Co., 245 N.C. 408, 96 S.E.2d 408 (1957).

<sup>146</sup> The court cited Smithwick v. Whitley, 152 N.C. 369, 67 S.E. 913 (1910), for

A premium also is often payable by the borrower upon default. It may be called "interest after default," "late payment fee," or "accelerated interest."<sup>147</sup> Stipulation in the loan agreement that the borrower will pay this sort of fee does not violate the usury statute though it is in addition to the legal interest rate. The excess charge is, however, penal and can be "neither collected nor retained."<sup>148</sup> Thus, where separate notes were executed by a borrower for each installment due, the lender was not allowed to collect interest beyond that already accrued when he accelerated payment upon default.<sup>149</sup> This approach is in keeping with the North Carolina court's general disfavor of such penalties.<sup>150</sup>

The sale of credit insurance is another route to additional profit for the lender. When an insurance company lends money, it can require as a precondition for the loan that the borrower purchase from it an insurance policy. So long as the borrower pays the same rates as do other insureds, the usury statute does not apply. Furthermore, the company can require that the policy be assigned as security.<sup>151</sup> The insurer thus makes a profit both on the loan and on the insurance policy. Institutional lenders are also authorized by statute to act as licensed insurance agents.<sup>152</sup> Some lenders reap a significant portion of their net profit from commissions on the sale of insurance.<sup>153</sup> Significantly, the North Carolina Supreme Court recently held<sup>154</sup> that a lender can require a borrower to place credit insurance with the lender's insurance subsidiary and that the premiums

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the general proposition that a debtor is not acting under duress when he pays a price to exercise a privilege otherwise unavailable to him.

<sup>147</sup> See Prather, *Mortgage Loans and the Usury Laws*, 16 BUS. LAW. 181, 192 (1960).

<sup>148</sup> *Ridley v. Jim Walter Corp.*, 272 N.C. 673, 679, 158 S.E.2d 869, 873 (1968), quoting with approval Annot., 84 A.L.R. 1283 (1933). See *Moore v. Cameron*, 93 N.C. 51 (1885).

<sup>149</sup> *Moore v. Cameron*, 93 N.C. 51 (1885).

<sup>150</sup> See cases cited note 133 *supra*.

<sup>151</sup> N.C. GEN. STAT. § 58-32 (1965). The premiums for such a required policy were held usurious in *Cater v. Life Ins. Co.*, 122 N.C. 338, 30 S.E. 341 (1898), and in *Miller v. Life Ins. Co.*, 118 N.C. 612, 24 S.E. 484 (1896), which resulted in the enactment of this statute. The statute is applied in *Cowan v. Security Life & Trust Co.*, 211 N.C. 18, 188 S.E. 812 (1936). As to the constitutionality of the statute, see note 17 *supra*.

<sup>152</sup> N.C. GEN. STAT. § 58-51.4 (1965).

<sup>153</sup> *E.g.*, forty-three percent of the income of North Carolina small loan companies in 1951 came from commissions on the sale of insurance. Simpson, *The Loan Shark Problems in the Southeastern States*, 19 LAW & CONTEMP. PROB. 68, 80 (1954).

<sup>154</sup> *Huski-Bilt, Inc. v. First-Citizens Bank & Trust Co.*, 271 N.C. 662, 157 S.E.2d 352 (1967).

paid are not to be considered in determining the presence of usury.<sup>155</sup> A reasonable extrapolation of this holding would indicate that the lender who is also an insurance agent can require that he get the commission for any credit insurance involved in a loan.<sup>156</sup> The inherent opportunities for coercion are self-evident.

### *Broker's Fee*

"[O]ne who makes no loan but, as broker or agent of the borrower, finds a lender and procures the making of a loan by him, has not received usury when he collects a fee for his services. If, however, the lender himself charges a commission in addition to the maximum rate of interest permitted by the statute, such charge is usury."<sup>157</sup> This recent opinion by the North Carolina Supreme Court demonstrates adherence to the general rule regarding brokerage fees.<sup>158</sup> An intermediary's fee is consideration for services rendered rather than for the use of money. But, if the broker be an agent for the lender, any compensation received by him will be attributed to the lender as usurious.<sup>159</sup> This rule is normally based on the theories that an agent whose purpose is to arrange loans for the lender should be compensated by the lender and that responsibility for an agent's acts should be assumed by the lender.<sup>160</sup>

The status of broker is susceptible to use as an evasive device. An insurance company deposited funds with a bank for a six percent return and the bank loaned the money out at six percent annual interest plus a "brokerage fee." These facts were held to raise no reasonable inference that the bank was in fact a broker but, rather, an inference that the bank had made a usurious loan on its own behalf.<sup>161</sup> Indeed, commercial banks usually obtain lendable funds from their own sources of credit and then relend them for a margin of profit. A bank may, however, be considered an independent broker in a properly structured transaction. Where a borrower specifically asked the bank to obtain a loan for him from an-

<sup>155</sup> *Id.* at 669, 157 S.E.2d at 357, quoting Annot., 91 A.L.R.2d 1344, 1349 (1963).

<sup>156</sup> Other states have prohibited this practice by statute: *e.g.*, NEV. REV. STAT. § 662.190(2) (1967) ("No bank shall act as agent for any insurance company"); N.M. STAT. ANN. § 48-22-67 (1953) ("Requiring procurement of insurance from a particular source as condition of a loan is unlawful.")

<sup>157</sup> *Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 263, 160 S.E.2d 39, 46 (1968). See *Patterson v. Blomberg*, 196 N.C. 433, 146 S.E. 66 (1929); *Nance v. Welborne*, 195 N.C. 459, 142 S.E. 477 (1928).

<sup>158</sup> See generally Annot., 52 A.L.R.2d 703 (1957).

<sup>159</sup> *Williams v. Rich*, 117 N.C. 235, 23 S.E. 257 (1895).

<sup>160</sup> Annot., 52 A.L.R.2d 703, 708 (1957).

<sup>161</sup> *Swamp Loan & Trust Co. v. Yokley*, 174 N.C. 573, 94 S.E. 102 (1917).

other source and agreed to pay a fee "to cover all costs, commission, and expense in securing said loan," the fee was not treated as usurious interest.<sup>162</sup>

### *The Collateral Transaction*

A lender may seek to enhance his profit beyond permissible limits by engaging the borrower or some other party in a transaction ostensibly not a part of the loan. But, wherever "directly or by indirection" an unlawful return has been knowingly taken or charged, the usury statute must be applied.<sup>163</sup> These machinations vary in sophistication and complexity. Neither execution of a separate note, devoid of usury on its face, for usurious interest<sup>164</sup> nor the simple expedient of assigning the note to a third party<sup>165</sup> has proved sufficient to avoid the statute. More exotic devices have been more successful. The required purchase of credit insurance and the collateral sale and repurchase cases discussed above are good examples.<sup>166</sup> Both of these transactions were structured around the corporate entity. In each case, the lender was allowed the protection of its corporate veil because the party pleading usury failed to satisfy the court that there was identity and unity of action between the lending corporation and its officers or its subsidiary.<sup>167</sup>

Where the corporate veil has not been interposed, the collateral transaction and the loan have been treated as one. Thus, a bank requiring a borrower to maintain with it a non-interest bearing minimum deposit and in addition charging maximum legal interest on the loan is guilty of usury.<sup>168</sup> "This kind of usurious agreement has been cast in various forms, but the courts have invariably stripped it of its flimsy disguise, and decided according to its substance and its necessary tendency and effect, when the purpose and intent of the lender are unmistakable. . . . The

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<sup>162</sup> Life Ins. Co. v. Smathers, 212 N.C. 40, 192 S.E. 851 (1937).

<sup>163</sup> Charles A. Riley Co. v. W.T. Sears & Co., 154 N.C. 509, 517, 70 S.E. 997, 1000 (1911).

<sup>164</sup> Hill v. Lindsay, 210 N.C. 694, 188 S.E. 406 (1936); Ector v. Osborne, 179 N.C. 667, 103 S.E. 388 (1920); Beck v. Bank of Thomasville, 161 N.C. 201, 76 S.E. 722 (1912).

<sup>165</sup> Overton v. Tarkington, 249 N.C. 340, 106 S.E.2d 717 (1959).

<sup>166</sup> See Huski-Bilt, Inc. v. First-Citizens Bank & Trust Co., 271 N.C. 662, 157 S.E.2d 352 (1967); Sledge Lumber Corp. v. Southern Builders Equip. Co., 257 N.C. 435, 126 S.E.2d 97 (1962).

<sup>167</sup> Cases cited note 166 *supra*.

<sup>168</sup> English Lumber Co. v. Wachovia Bank & Trust Co., 179 N.C. 211, 102 S.E. 205 (1920); Planters Nat'l Bank v. Wysong & Miles Co., 177 N.C. 380, 99 S.E. 199 (1919).

proper subject of inquiry is, what is the lender to receive, and not always what the borrower is to pay, for the forbearance."<sup>169</sup>

#### WHAT LAW GOVERNS?

Credit that is unavailable to prospective borrowers in North Carolina because of a low interest ceiling will often be furnished by financiers from states that permit higher rates. Some out-of-state lenders maintain branches in North Carolina and solicit business, which is channelled to the lender's home office. At the home office, negotiations handled by the branch are approved and the formal indicia of contract are finally executed. The agreement normally contains a stipulation that the law of the lender's state is to apply to the transaction. Evidences of indebtedness and of security interests in collateral are kept at the home office, which is designated as the place where repayment is to be made.<sup>170</sup>

This arrangement has been held to exempt the loan from North Carolina's usury law. "Where notes are executed in one State and payable in another, the parties will be presumed to have contracted with reference to the law of the place where the transaction would be valid. . . ."<sup>171</sup> The court further held that the contract was made at the place where the last act necessary to its existence was done—the home office—and that, generally, the validity of a contract is to be determined by the *lex loci* where it was made.<sup>172</sup> But, the *lex forum* is to be applied if the contract is executed in bad faith to evade the usury laws or if the loan is secured by realty in the forum state. Under both of these circumstances, North Carolina's public policy is deemed to override the usual rule of comity between states.<sup>173</sup>

In a tight credit market, where funds are not available at licit rates, the borrower seeks out-of-state financing not because of a corrupt intent

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<sup>169</sup> *Planters Nat'l Bank v. Wysong & Miles Co.*, 177 N.C. 380, 388, 99 S.E. 199, 204 (1919).

<sup>170</sup> *Bundy v. Commercial Credit Co.*, 200 N.C. 511, 157 S.E. 860 (1931). See *Clarkson v. Finance Co. of America*, 328 F.2d 404 (4th Cir. 1964).

<sup>171</sup> *Bundy v. Commercial Credit Co.*, 200 N.C. 511, 157 S.E. 860, 862 (1931).

<sup>172</sup> An earlier case held an alleged usurious contract both made and performed in Virginia to be subject to Virginia law. *Hilliard & Co. v. Outlaw*, 92 N.C. 266 (1885). The more recent decisions are not necessarily in conflict with this ruling since it did not state a requirement that both agreement and performance take place outside the forum state.

<sup>173</sup> *Bundy v. Commercial Credit Co.*, 200 N.C. 511, 157 S.E. 860, 864-66 (1931). The usual rule of comity between states is demonstrated in *Union Trust Bank v. Ward*, 202 N.C. 691, 163 S.E. 926 (1932) (*per curiam*), which held a loan made by a bank in Tennessee at rates legal in that state to be non-usurious and enforceable in the North Carolina courts.

to evade the usury laws but because commercial necessity so dictates. By like reasoning, the lender makes loans only from its home office because of a need to supervise its credit policies. If this be the case, then few such contracts are sufficiently contrary to North Carolina's interest policy to invoke its usury law.<sup>174</sup> The real limiting factor is the rule that all loans secured by North Carolina real estate are subject to local interest law.<sup>175</sup> Many, if not most, financing transactions involve realty as collateral.<sup>176</sup>

#### AN APPRAISAL

The state of credit cost regulation in North Carolina is deplorable. Existing legislation is devoid of rational pattern and is scattered throughout the General Statutes. Any effort, short of reading every statute on the books, to exhaustively study and catalogue these enactments is doomed at the outset.<sup>177</sup> Exceptions to the general usury statute have not been enacted through a studied approach to the important cost of credit problem. Instead, they have been ad hoc responses to stimuli provided by the various special interest groups that have felt the squeeze of the six percent per annum legal interest rate. There has been no legislative recognition that each statutory exception embodies a decision of public policy allowing a particular class of borrowers or lenders to engage in financing activities legal for it but illegal for others in essentially similar commercial situations. Unreasonable discrimination is present with a vengeance when the availability of credit at licit rates to a business depends upon whether it is a corporation or a proprietorship, or upon whether it offers as collateral accounts receivable or real estate. Legislators who would blanch at the mention of price fixing for commodities other than money blithely grant dispensations<sup>178</sup> from the general usury statutes at random without serious consideration of the problems involved.

Not even a well-reasoned usury statute could successfully set an arti-

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<sup>174</sup> For cases where intent to evade the usury laws was found by the jury, see *Polikoff v. Finance Serv. Co.*, 205 N.C. 631, 172 S.E. 356 (1934); *Ripple v. Mortgage & Accept. Corp.*, 193 N.C. 422, 137 S.E. 156 (1927).

<sup>175</sup> *Meroney v. Atlanta Bldg. & Loan Ass'n*, 116 N.C. 882, 21 S.E. 924 (1895). Usury does not affect the validity of a mortgage as to the principal amount of the underlying obligation. *Rogers v. Booker*, 184 N.C. 183, 113 S.E. 671 (1922).

<sup>176</sup> As to conflict of laws and usury, see generally Annot., 125 A.L.R. 482 (1940).

<sup>177</sup> The N.C. GEN. STAT. INDEX (1965) is far from comprehensive as to its "usury" and "interest" headings and should not be relied upon.

<sup>178</sup> Ironically, in view of usury's ecclesiastic origins, the latest dispensation, granted by the North Carolina General Assembly as this comment went to press, reportedly allows churches to borrow at seven percent per annum interest. *Charlotte (N.C.) Observer*, Mar. 8, 1969, § A, at 9, col. 4.

ficially low price for money as long as the economic law of supply and demand operates to drive the market rate above that price.<sup>179</sup> When this occurs, the usury law creates a classic dilemma. If the statute is obeyed and alternative avenues of investment are available for potential lenders, credit sources both within and without the state dry up with a resulting atrophy of economic growth.<sup>180</sup> If the statute is ignored, disrespect for the law<sup>181</sup> is fomented in legitimate commercial circles and unscrupulous lenders enter the market.<sup>182</sup> The latter horn of the dilemma is often chosen because usury is regarded as purely *malum prohibitum* and carries no moral opprobrium.<sup>183</sup> Risk of loss from statutory penalties is treated as a burden of doing business and is passed along to the borrower through increased financing charges.<sup>184</sup> There is, however, little risk of loss since few usury actions arise out of the many financing transactions that take place. Few borrowers have the temerity to offend financiers whom they must approach for credit in the future.<sup>185</sup>

Despite protestations that substance must control form, the North Carolina courts have created exemptions from the usury laws by drawing distinctions based purely upon form. The most significant example is the time price doctrine distinguishing credit sales from loans. While these decisions have allowed free credit flow where commercially expedient, they have not contributed to predictability and certainty in financial planning. Though credit dealings may often be structured to avoid interest limits,

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<sup>179</sup> *E.g.*, Shanks 329.

<sup>180</sup> Prather, *Mortgage Loans and the Usury Laws*, 16 BUS. LAW. 181, 196 (1960). Prather advises mortgage lenders in low interest rate states to buy loans in other states where permissible rates are higher.

<sup>181</sup> Disregard for the usury laws is not a new phenomenon. Clark, C.J., concurring in *MacRackan v. Bank of Columbus*, 164 N.C. 24, 80 S.E. 184 (1913), had the following to say about a bank adjudged guilty of usury: "It is astonishing that those who are indebted for the protection of their property and their business entirely to the respect which the people shall show to the law should thus inculcate by their daily conduct contempt for the law. The law against usury is as much the law of the state, and to be respected as such, as the law against burglary and larceny." *Id.* at 39, 80 S.E. at 190.

<sup>182</sup> Shanks 329-31.

<sup>183</sup> Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 54, 56 (1941).

<sup>184</sup> *Id.*

<sup>185</sup> Many usury actions are brought by trustees in bankruptcy, receivers and other fiduciaries who are duty bound to assert all claims and defenses. *See, e.g.*, *Clarkson v. Finance Co. of America*, 328 F.2d 404 (4th Cir. 1964); *Polikoff v. Finance Serv. Co.*, 205 N.C. 631, 172 S.E. 356 (1934); *Bundy v. Commercial Credit Co.*, 200 N.C. 511, 157 S.E. 860 (1931); *Ripple v. Mortgage & Accept. Corp.*, 193 N.C. 422, 137 S.E. 156 (1927); *Charles S. Riley & Co. v. W.T. Sears & Co.*, 154 N.C. 509, 70 S.E. 997 (1911).



such planning is necessarily speculative. A particular avoidance device may or may not perform its function if challenged. There is no quick and effective way that the parties to a credit transaction can determine which of the melange of usury rules is relevant to their problem.

The oft-proclaimed purpose of usury law has been protection of the borrower. Because they do not meaningfully discriminate between borrowers who need protection and borrowers who do not, current attempts to regulate the price of money fall far short of this goal.<sup>186</sup> Without rational bases in the needs of a complex credit economy, usury laws are neither respected nor obeyed.

### CONCLUSION

Only thorough statutory reform can untangle North Carolina's convoluted scheme of credit cost regulation. The General Assembly must enact measures that take a unified, functional approach to the problem, emphasizing economic realities rather than purely formal distinctions. A new credit regulation statute should disregard meaningless differences in form such as those that support the corporate exception and the time price doctrine. Indeed, it should avoid altogether the classification of transactions under rigid rules that allow creditors to evade public policy as to credit cost through clever subterfuge. Most importantly, a new statute must recognize the futility of artificially low rate ceilings.

The most recent and most comprehensive proposal for state action regarding the usury problem is the Uniform Consumer Credit Code.<sup>187</sup> It seeks to eliminate credit cost controls for "knowledgeable and sophisticated credit recipients" and to protect "less knowledgeable and less sophisticated credit recipients" through, *inter alia*, disclosure requirements, ceilings on credit costs to eliminate overreaching, and administrative remedies for redress against creditors.<sup>188</sup> To accomplish these ends, the Code simply draws new rigid lines. For example, all business-purpose loans or credit sales of more than twenty-five thousand dollars as well as all credit sales and loans to corporations are subject to no statutory ceiling.<sup>189</sup> A basic maximum rate of eighteen percent per annum is set for consumer, agricul-

<sup>186</sup> This is not to say that usury law is completely ineffective as a tool for protection of the naive consumer. See, e.g., *Ridley v. Jim Walter Corp.*, 272 N.C. 673, 158 S.E.2d 869 (1968), where a shell home builder was restrained from foreclosing a real estate mortgage because of a usurious attempt to collect "accelerated" interest.

<sup>187</sup> UNIFORM CONSUMER CREDIT CODE (Rev. Final Draft Nov. 1968).

<sup>188</sup> *Id.* Prefatory Note.

<sup>189</sup> *Id.* § 2.605.

tural, and small business loans or credit sales.<sup>190</sup> These rules seem to assume that a consumer or small businessman is always unsophisticated and that one who obligates himself for large sums or who operates a corporation is necessarily knowledgeable as to credit matters. They are likely to prove as dysfunctional in practice as those rules that they are intended to replace, for it cannot be said that no overreaching occurs in credit transactions beyond a certain magnitude nor can it be reasonably asserted that rate limitations are universally desirable in consumer credit transactions.

A better solution to the usury problem in North Carolina is a legislative program characterized by flexibility and by commercial viability. The following statutory changes should be considered for inclusion in any such program. First, full disclosure should be required in *all* credit dealings. Congress has already acted to assure the consumer sufficient information to make an intelligent choice among the sources of credit available to him. The Consumer Credit Protection Act,<sup>191</sup> which becomes effective July 1, 1969, does not attempt to regulate credit charges, but leaves this task to the state.<sup>192</sup> Second, the North Carolina Consumer Finance Act<sup>193</sup> should perhaps be broadened to regulate all lenders who regularly lend in amounts of less than two thousand dollars and to regulate all those sellers whose net profit results substantially from the extension of credit. The Act, as so revised, should be vigorously enforced by an adequate administrative body. Its purpose would be to supervise creditors who habitually deal with those consumers most susceptible to credit abuses—the lower income groups. Finally, the courts should be given an explicit statutory mandate to enforce

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<sup>190</sup> *Id.* § 3.201.

<sup>191</sup> Act of May 29, 1968, Pub. L. No. 90-321, 82 Stat. 146 *et seq.*

<sup>192</sup> The Consumer Credit Protection Act is implemented by Proposed Federal Reserve Regulation Z, 12 C.F.R. § 226 (1968).

[T]he purpose of the Act . . . is to assure that every customer who has need for loan or sale credit for personal, family, household, or agricultural purposes is given meaningful information as to the cost of credit, in most cases expressed in dollars of finance charge and an annual percentage rate computed on the declining unpaid balance. Other relevant terms must also be disclosed so that the customer may readily compare the various credit terms available to him and use consumer credit on an informed basis to his best advantage . . . [under the Act] a customer has a right to cancel a credit transaction which involves a lien on his residence, other than a purchase money first lien, and void that lien without any liability by notifying the creditor of his cancellation within three business days. All advertising of consumer credit terms must comply with specific standards, and certain credit terms may not be advertised unless they are made available to all who qualify.

*Id.* § 226.1.

<sup>193</sup> N.C. GEN. STAT. §§ 53-164 to -191 (1965), as amended (Supp. 1967).

a public policy against unconscionability and overreaching in any credit transaction.<sup>194</sup> A trial court could weigh all the circumstances surrounding a transaction in light of current economic conditions and thus determine whether the profit reserved was palpably unfair as well as the result of unconscionable activity by the creditor. The court's finding of unconscionable usury should carry a penalty severe enough to make such practices unprofitable, but not so severe as to make the courts reluctant to impose them.

Such a statutory scheme of complete disclosure, of continuing regulation where most needed and of flexible enforcement of public policy would not become a stultified vestige of the past, as has the present law, but would conform itself to the changing economic needs of the future.

DAVID McDANIEL MOORE II

## Antitrust—"Cross-Media" Ownership and the Antitrust Laws— A Critical Analysis and a Suggested Solution

### INTRODUCTION

For many years newspapers have owned broadcast stations<sup>1</sup> competing in the same metropolitan area, but only recently has concern been ex-

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<sup>194</sup> Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party. Whether a meaningful choice is present in a particular case can only be determined by consideration of all the circumstances surrounding the transaction. . . . The manner in which the contract was entered is also relevant to this consideration. . . .

*Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965). Corbin suggests the test should be whether the terms are "so extreme as to appear unconscionable according to the mores and business practices of the time and place." 1 A. CORBIN, *CONTRACTS* § 128 (1963). In this connection, it should be noted that the North Carolina General Assembly omitted U.C.C. § 2-302, which enacts the unconscionability doctrine as to sales, from the North Carolina version of the Uniform Commercial Code, N.C. GEN. STAT. §§ 25-1-101 to -10-107 (1965), and that the North Carolina Supreme Court has never explicitly applied the unconscionability doctrine. An early decision stated that equity would set aside a contract "grossly against conscience or grossly unreasonable." *Barnett v. Spratt*, 39 N.C. 171, 174 (1845) (dictum). A later case has produced a result, based upon consideration theory, which seems justifiable only upon grounds of unconscionability. *Swift & Co. v. Aydtlett*, 192 N.C. 330, 135 S.E. 141 (1926).

<sup>1</sup> The broadcast media under consideration will be AM and FM radio and VHF and UHF television. The "duopoly" rules adopted by the FCC restrict ownership by one person of AM, FM, and television stations to one station of each type in